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IN THE

Supreme Court of the United States

OCTOBER TERM 1932

No. 475

DAVID BURNET, COMMISSIONER OF INTERNAL REVENUE,

Petitioner,

vs.

S. & L. BUILDING CORPORATION.

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT.

BRIEF ON BEHALF OF RESPONDENT

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Opinions Below.

The opinion of the Circuit Court of Appeals (R. 42-44) is reported in 60 F. (2d) 719. The findings of fact and opinion of the Board of Tax Appeals (R. 26-33) are reported in 19 B. T. A. 788.

Jurisdiction.

The judgment of the Circuit Court of Appeals was entered July 26, 1932 (R. 45). Petition for certiorari was filed on October 25, 1932 (R. 45), and granted December 5, 1932 (R. 45). Jurisdiction is conferred upon this Court

by Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

Questions Presented.

The respondent, in its brief in opposition to the petition for a writ of certiorari, submitted to this Court as the question presented, the following:

Whether the first sentence of the last paragraph of Article 44 of Treasury Regulations 69, as amended, is valid when applied to the facts in this case involving the sale of mortgaged property where the purchasers assumed the mortgages which were originally given by the seller (respondent) which remains liable thereon, until actual payments are made by the purchasers of the property.

This question, properly subdivided, presents to this Court the several questions which the respondent herein presented to the Circuit Court of Appeals. These questions substantially are as follows:

1. Whether, in the case of sale of real estate reported on the installment plan where the purchaser assumed the unpaid mortgage loans which were originally obtained by the seller (respondent), the "total contract price", as that term is used in Section 212 (d) of the Revenue Act of 1926, includes the mortgages assumed.

2. Whether the payments made by the purchaser direct to the mortgagees on the mortgages assumed by him are to be included by the seller as part of the "initial payments" in the year of sale, and as part of "installment payments actually received", as those terms are used in Section 212 (d) of the Revenue Act of 1926.

3. Whether an item, representing the excess of the mortgages assumed over the cost basis or other basis of the property, is to be reported as income by the seller in the year of sale.

Statute and Regulations Involved.

The applicable statutes and regulations are set forth in the petitioner's Appendix (pp. 24-26).

Additional regulations, which the respondent deems applicable, are set forth in the Appendix, pp. 28-29, *infra*.

Statement.

All of the facts material to the present issue are set forth in the petitioner's brief (pp. 2-7), with the exception that the respondent deems it material to add that the mortgage loans which were assumed by the purchaser were obtained by the respondent prior to the sale of the properties. The first mortgage loan of $1,100,000.00 on 82nd Street and Broadway property was obtained by respondent in the year 1923 (R. 27). First mortgage loan on 83rd Street and Broadway property of $1,100,000.00 and second mortgage loan of $500,000.00 were obtained by the respondent in the year 1924 (R. 27).

Summary of Argument.

The statute involved is Section 212 (d) of the Revenue Act of 1926. This section provides a new method for taxing gross profits realized from the installment sales of property. It was designed to allow a taxpayer in the case of installment sales to spread the profits over the whole period during which payments were made so as to avoid loading all of it upon those years which followed the amorti-

zation of the original cost. The formula determining the profit reportable on the installment sales is found in the statute itself. In this formula the term "total contract price" is used. This term, if to be applied at all to the sales of real property, includes the mortgages assumed by the purchaser.

The Commissioner is authorized to make regulations interpreting the statute, but such regulations must be reasonable and consistent. The regulations adopted by the Commissioner are not consistent in the interpretation of the statute for the reason that the words of the statute are read in one sense in one connection and differently in another. The Commissioner includes all mortgages assumed in the "purchase price" but excludes them to the extent they exceed the "basis" from the "initial payments" and the "total contract price". The effect of this is to treat as "installments actually received" in the year of sale that portion of the mortgages assumed by the vendee which exceeds the "base". Again this excess of mortgages assumed over the base is excluded from the denominator of the fraction to be applied to each "installment actually received" to determine the taxable profit included in that installment, while the minuend for determining the total taxable profit includes all of the mortgages assumed.

To be consistent the regulations adopted by the Commissioner should include the payments made by the purchasers on the mortgages assumed to the mortgagees as part of the "initial payments" and as part of "installment payments actually received" as those terms are used in Section 212 (d). The application of this method would result in there being no excess of the mortgages assumed over the basis of property in calculating profits on the install-

ment plan. Further, no profit escapes tax, nor is any year unduly loaded with profit.

Under the ruling of the Court below, holding the regulations invalid, a consistent method of calculating the return of profits is adopted. The method approved does no great violence to the words in the section; it results in an equitable method; it is not unfair even though it may result in imposing a tax after direct payments have ended, for the section is not compulsory but merely gives an option and the taxpayer may not object to what he can avoid. The decision below is consistent with the general scheme of the Revenue Acts, the recognized accounting principles and gives effect to the purpose of the statute in question.

ARGUMENT.

POINT I.

Section 212 (d) of the Revenue Act of 1926 provides for a new method for taxing gross profits realized from the installment sales of property which has for its purpose the spreading of the profit over the whole period during which payments are to be made by purchasers.

Prior to the enactment of Section 212 (d) of the Revenue Act of 1926, there existed no express provision for reporting income on the installment basis. *Appeal of B. B. Todd, Inc.*, 1 B. T. A. 762; *Appeal of H. B. Graves Co., Inc.*, 1 B. T. A. 859; *Appeal of The Hoover-Bond Co.*, 1 B. T. A. 929.

The dual basis for reporting taxable income, namely, the basis of cash receipts and disbursements or the basis of accrual, were the only two methods of reporting income

authorized by earlier Revenue Acts. Section 212 (d) of the Revenue Act of 1926, created a third basis separate and apart from cash receipts and disbursements or accrual bases. The Committee on Finance, in submitting its report to accompany H. R. 1 on the Revenue Bill of 1926, entitled Senate Report #52, 69th Congress, First Session, clearly stated, in discussing the proposed Section 212 (d), that it was to provide a third method of reporting income. It was said in that report, at page 19:

> "Section 212 (d): The revenue act of 1924 and prior acts have specifically provided two bases only for reporting income—first, cash receipts and disbursements, and, second accrual. Since the enactment of the revenue act of 1921, however, section 202 (f) and its successors have impliedly recognized the existence of a third basis, the installment basis, without in anywise defining the situations and businesses to which such basis might be applied. The Commissioner of Internal Revenue has in his regulations provided, in pursuance of his authority to require a method of computation that will clearly reflect income, the installment basis for reporting income in certain cases. * * *
>
> "However, recent decisions of the Board of Tax Appeals (see appeal of 650 West End Ave. Co., appeal of Manomet Cranberry Co., and appeal of B. B. Todd (Inc.)—all decided during the past year) have held that similar regulations under earlier acts were invalid and that the commissioner under the law could authorize no basis other than the cash receipts and disbursements basis or the accrual basis, except for certain minor departures. The committee amendment, in order to meet the situation resulting from the decisions, places the principles of the commissioner's regulations in the law and thereby validates the regulations for all periods after January 1, 1925."

The method to be employed in calculating taxable income from the sale of property under each basis is as follows:

(a) *Cash Basis*—Under the cash basis of reporting profits from the sale of properties, the consideration for the sale of the property when realized in cash or its equivalent is first applied to the cost or the basis of the property sold, and any amount in excess thereof, when received, constitutes taxable profit in the year of receipt.

(b) *Accrual Basis*—Under the accrual basis for reporting income, the entire profit is considered taxable during the year in which the sale of the property is made.

(c) *Installment Basis*—Under the installment basis for reporting profits from the sale of property, the profits are apportioned and spread over the whole period during which payments are to be made so that a portion of the payments, when made, represents profit and a portion thereof represents a return of the cost or basis.

It is not necessary to discuss the deferred payment sales not on the installment plan, except to state that the Commissioner applies this method to cases which do not come within the 25% limitation under Section 212 (d) of the 1926 Act. This method precludes a taxpayer from reporting the profits on the installment plan.

The Commissioner, in Articles 44 and 45 of Regulations 69 and earlier regulations, separated deferred payments into two classes:—(1) Sale of property on the installment plan, and (2) Deferred payment sales not on the installment plan.

Under Article 45, Regulations 45, dealing with the sale of real estate on the installment plan, the Commissioner

treats the installment obligation assumed by the buyer as follows:

> "* * * installment obligations assumed by the buyer are not ordinarily to be regarded as the equivalent of cash, and the vendor may report as his income from such transactions in any year that proportion of each payment actually received in that year which the gross profit to be realized when the property is paid for bears to the gross contract price. * * *"

The later Regulations of the Commissioner, Article 45[1], Regulations 62 and 65, had a slight change in wording from that of Article 45, Regulations 45. This change in no way affected the treatment of installment sales.

It is apparent from these Regulations, which in principle, according to the Senate Report above referred to, were to be enacted into the law (Section 212 (d)), that the mortgages assumed were not to be treated as the equivalent of cash, but were to be considered as part of the consideration which, when paid, was to be returned by the seller as taxable income in the proportion which the gross profit bears to the gross contract price.

The installment basis for reporting income was designed to allow a taxpayer, in the case of installment sales, to spread the profit over the whole period during which payments were made, so as to avoid loading all of it on those years which followed the amortization of the original cost. (See Opinion L. HAND, *C. J.*, in this case, C. C. A., Second Circuit.) (R. 42-44.) Consequently, it was the intent of Congress, when enacting Section 212 (d), to prescribe a formula for reporting profits on the installment plan. This formula has for its denominator, or base, the total or gross contract price, and for its numerator, the

[1]Article 45, Regulations 65 and 69, are set forth in the Appendix, pp. 28, 29.

gross profit. The ratio or percentage obtained therefrom is then applied to each payment required to be made by the purchaser pursuant to the purchase contract.

If the petitioner's conception of the purpose of Section 212 (d) is correct, it will be difficult to distinguish between the different methods of reporting profit without confusing or intermingling one with the other. Under his interpretation[2] of the statute, there apparently would be no segregation of the payments received in relation to cost and profit. The petitioner treats, contrary to his prior regulations, the mortgages assumed as the equivalent of cash received by the seller, and applies the entire amount of the mortgages assumed in amortizing the cost or basis of the property sold. This is contrary to the principle of reporting profits on the installment plan.

The taxpayer must be consistent in its method of reporting income. Section 13 (d) of the Revenue Act of 1916 has been construed by this Court, and it was held that taxpayers were not permitted to file returns upon a mixed basis of receipts and disbursements as to some items and accrual as to other items, as such a return would not reflect true net income. *United States* v. *P. Chauncey Anderson, et al., etc.*, 269 U. S. 422.

In Section 212 (b) of the Revenue Acts of 1921, 1924 and 1926, Congress substantially re-enacted the provisions of Section 13 (d) of the Revenue Act of 1916. A new section was added to Section 212 of the Revenue Act of 1926, namely, Section 212 (d), which provides for reporting profit on the installment plan. With this new provision the three methods of reporting income, discussed above, were recognized by Congress—(1) Cash receipts and disbursements, (2) Accrual, and (3) installment.

[2]Article 44, Regulations 69, set forth in Appendix, p. 28.

Any one of these methods, when properly applied, should by itself clearly reflect income. A mixed basis is not permissible. *United States* v. *P. Chauncey Anderson, et al., etc., supra.* To apply different methods to a single transaction would obviously not reflect true net income. This is precisely what the Commissioner proposes in the respondent's case. He concedes that the installment method is proper, in the case before the Court. (Pet. br., p. 13, line 4, last par.) The Commissioner treats the excess of the mortgages assumed over the basis, in the sale of the 83rd Street and Broadway property, as taxable profit in the year 1925 for the reason that the taxpayer filed the return on the accrual basis. To support this treatment of the excess of the mortgages assumed, he relies upon the first sentence of the last paragraph of Article 44 of Treasury Regulations 69, as amended. The respondent's method is not open to this criticism.

The respondent's method of computing income on the installment plan presents no difficulties of administration. On the contrary, it establishes an equitable uniform basis which may be followed by all taxpayers who elect to return the profit from the sale of property on the installment plan. The taxpayer's books, if properly maintained along the lines of recognized accounting procedure, should reflect, according to either the respondent's or petitioner's method of reporting profit on the installment plan, appropriate accounts, including accounts variously designated as "Deferred Profits from Sale of Properties on Installment Plan", or "Reserve for Unrealized Profits from Sale of Properties on Installment Plan". This account at all times reflects the amount of profit not as yet realized. Appropriate journal entries are made at the end of each calendar or fiscal year transferring from this account the

realized profit computed in accordance with respondent's method.[3] The difficulties of administration and bookkeeping urged by the petitioner are seeming rather than real. Even if such difficulties were real, it has been held that income is a "matter of fact—not of bookkeeping". *Maryland Casualty Company* v. *United States*, 251 U. S. 342; *B. B. Todd, Inc.*, 1 B. T. A. 762.

POINT II.

The "total contract price", as that term is used in Section 212 (d) of the Revenue Act of 1926, if to be applied at all to sales of real property, includes the mortgages assumed by the purchaser.

The statute, Section 212 (d) of the Revenue Act of 1926 does not require, nor does it prescribe a different computation than that which the respondent used. True the statute says that the Commissioner may make regulations, but in the statute itself we find the formula for determining the profit reportable on installment sales. This formula is not the one approved by the Board of Tax Appeals in the instant case. The formula uses the phrase "total contract price" in connection with sales of personalty. It is the respondent's contention that if this phrase is to be applied to sales of real property, then the phrase includes mortgages assumed. This contention of the respondent has received the approval of the Circuit Court in the instant case. The Circuit Court, in its opinion, approves this contention by stating:

> "Again, the regulation involves an equivocal use of the phrase, 'total contract price'. Obviously the denominator of the fraction to be applied to each 'in-

[3]See Appendix, p. 30, for appropriate journal entries.

stallment actually received', must be the sum of all such installments. If it be larger, the whole profit will never be covered. For this reason the regulation, which does not include among installments payments upon the assumed mortgages, excludes their face from the denominator. Yet in calculating the profit it necessarily includes the mortgages in the minuend, else there would ordinarily never be any profit. But the section, which necessarily implies that profit shall be reckoned by using a price which includes all the mortgages, can not mean something else when speaking of the denominator of the fraction. In defining the condition upon the privilege in the case of realty it uses the phrase, 'purchasing price', but that has nothing to do with the question here; it touches not the calculation of the income to be returned but the right to spread the profit at all. Nevertheless, it is extremely improbable that it means anything else than 'total contract price', and the commissioner here agrees that it includes assumed mortgages." (R. 43, 44.)

Section 212 (d) of the Revenue Act of 1926, and the report of the Committee on Finance accompanying H. R. 1, which discusses Section 212 (d) at page 19, indicates that the section was enacted by Congress for the sole purpose of affording relief to a certain class of taxpayers.*

This Section 212 (d), being a relief measure, should be construed most liberally in favor of the taxpayer. *Bowers* v. *New York & Albany Lighterage Co.*, 273 U. S. 346; *Walter G. Palmer, Trustee*, v. *The United States*, 67 Ct. Cls. 648.

It is an elementary principle of statutory construction that words in the statute should be given their plain and ordinary meaning and that a statute, if possible, will not be construed to lead to unjust or oppressive results.

*See pertinent portions of Senate Report #52, First Session, 69th Congress, Respondent's brief, p. 6.

In addition to the Commissioner of Internal Revenue giving the words "total contract price" an unusual meaning in the regulations, the respondent submits that the construction adopted by the Commissioner leads to unjust and oppressive results, and would result in a taxation of a larger proportion of the anticipated profit than was received in the taxable year. The following tables illustrate the differences between the method employed by the respondent and that of the petitioner in computing the tax:

82ND STREET AND BROADWAY PROPERTY

Year 1924

	Respondent's Method	*Petitioner's Method*
Total profit to be realized	$ 558,676.52	$ 558,676.52
Total contract price	2,100,000.00	1,000,000.00
Percentage of total profit to total contract price	26.603643%	55.86752%
Initial payments:		
Cash	300,000.00	300,000.00
Payments on purchase money mortgage	30,000.00	30,000.00
Payments on Dec. 1, 1924, on mortgage assumed	22,000.00	None
Total	$ 352,000.00	$ 330,000.00
Profit realized in 1924— (Total payments times percentage of total profit)	$ 93,644.82	$ 184,363.25

Year 1925

Payments made during the year 1925 on account of total contract price:		
Payments on purchase money mortgage	$36,250.00	$36,250.00
Payments on mortgages assumed	44,000.00	None
Total	$80,250.00	$36,250.00
Profit realized in 1925— (Total payments times percentage of total profit)	$21,349.42	$20,252.02

83RD STREET AND BROADWAY PROPERTY

Year 1925

	Respondent's Method	*Petitioner's Method*
Total profit to be realized	$ 642,967.00	$ 642,967.00
Total contract price	2,165,000.00	565,000.00
Percentage of total profit to total contract price	29.698244%	100 plus
Initial payments:		
Cash	300,000.00	300,000.00
Payments on purchase money mortgage	2,000.00	2,000.00
Payments during 1925 on first mortgage assumed	None	None
Payments on second mortgage assumed	22,500.00	None
Excess of mortgages assumed over basis of property to taxpayer	None	77,967.00
Total	$324,500.00	$379,967.00
Profit realized in 1925—		
(Total payments times percentage of total profit)	$96,370.80	$379,967.00

The effect of both the respondent's and petitioner's computations is to prevent any income from escaping taxation. The only difference is in the period of time during which the income is reported. In the respondent's method the profit is spread over the entire total payments to be received on account of the total contract price, which it is contended includes the mortgages assumed. The petitioner's method determines total contract price by excluding the mortgages assumed; hence shortening the period for reporting income.

What Congress intended seems clear. When the words "total contract price" were used, Congress evidently did not consider it necessary to define the meaning of the words. Because of the lack of a definition it must have meant that the words should have their ordinary and accepted meaning, but it is to be noted that Congress says "total contract price" not "contract price". In other words, Congress, it is submitted, clearly intended that the total contract price should include all considerations passing to the seller under the contract, and if the seller was to be relieved by the purchaser of a primary obligation on which it was liable, the amount of such obligation was to be included under "total contract price".

The only words in the section which Congress felt needed a definition were the words "initial payments", and Congress defined "initial payments" to include all payments received in cash or property other than evidence of indebtedness of the purchaser during the taxable period in which the sale or other disposition is made. If this definition had not been inserted in the law, "initial payments" might have been construed to include only those payments made on the closing of the sale. It would seem to follow that the absence of a definition of "total contract price" shows the intention of Congress to refer to the total price for the property as it might be fixed under the contract between the seller and the purchaser as "total contract price". In the instant case the contract fixed the price at $2,100,000.00 on the property sold during the year 1924 (R. 28), and the contract fixed the price at $2,165,000.00 for the property sold during the year 1925 (R. 29). Both of these contracts were payable as set forth in the statement of facts (R. 28, 29). The assumption of the mortgages was an essential part of the contracts and

was required so that the liability of the seller on such mortgages might be gradually reduced and the total profit to the seller might be actually realized. As these payments were made, the total profit to the seller was realized. The amount by which such mortgages (mortgages on both pieces of property) would be reduced in any year by payment by the purchasers to the mortgagees was the equivalent of a payment of similar amounts to the seller. *Appeal of James M. Butler,* 19 B. T. A. 718. Such payments represent income to the seller when made on the basis provided by Section 212 (d).

The respondent submits that it was the intention of Congress to provide an equitable method of taxation of profit upon the sale of real property under an installment plan and that the method prescribed by the Commissioner is not equitable, at least in the case which is now before this Court.

What difference, if any, is there between the "purchase price" and the "total contract price"? We believe none.

In the case of *Frank J. Bosshardt*, 4 B. T. A. 1262, the question arose as to what constituted "purchase price". That case involved the sale of lots for $11,000.00 not subject to mortgages or encumbrances. The taxpayer deducted from the selling price the commission of $550.00, Revenue stamps $11.00 and other expenses of $6.00, leaving a net purchase price of $10,433.00. The Board in deciding this case stated (p. 1264):

> "* * * In ascertaining the proportion of profit, the taxpayer has not followed exactly the method there prescribed, in that he has used the ratio which the total profit realized bears to the net sale price, whereas the statute specifies, instead of the net sale price, the 'total contract price'. This results in a slightly larger pro-

portion of profit than if the statutory method were used."

It is noted from this decision that the Board in this case held that the term "total contract price" is the same as the total selling price and not the net sales price.

In Senate Report #52 (Resp. br., p. 6), the term "contract price" has been used by the Committee to be the amount which is to act as a basis for figuring the limitation of 25% provided in Section 212 (d) as well as the basis for reporting the percentage of profit to be returned each year. In other words, no distinction was made in this report between "purchase price" and "total contract price", in so far as those terms are used in Section 212 (d).

If any distinction was intended by Congress between the words "total contract price" and "purchase price", the distinction is this. The term "purchase price" would in any case include the amount of any mortgage upon the premises, for such item would be included within the basis for determining gain or loss on a resale by the purchaser. On the other hand, if there was a mortgage upon the premises at the time of the sale, which was not a personal liability of the seller and which the purchaser did not agree to assume for the seller, the price as fixed by the contract might not include such mortgage. The contract might even make no reference to encumbrances upon the property, such as a first mortgage or taxes accrued against the property. This would amount to a sale of the equity. But in the case where the seller is personally liable upon the mortgage which is already upon the property, and it is provided by the contract of sale that the purchaser will assume the mortgage, then in any event such a mortgage is part of the total contract price for the assumption of the liability of

such mortgage by the purchaser is part of the consideration coming to the seller of the property.

We do not believe Congress thought of any such distinctions. "Total contract price" is used in the portion of the section dealing with personalty, "purchase price" in the portion dealing with realty. The reference back from the realty portion to the personalty portion is just to bring forward the method of computation.

The respondent submits that in the absence of a definition of the term "total contract price" in the statute, the Commissioner can only give to the term its ordinary and usual meaning. This meaning can only be the total price as fixed by the contract of sale, including all considerations inuring thereby to the seller. Where the purchaser agrees to relieve the seller of its primary liability on the mortgage by assuming the mortgage, the amount of this mortgage should therefore be considered as part of the contract price. The ordinary and usual meaning of the term "total contract price" is the price fixed by the contract. See *Vinton Petroleum Company* v. *Sun Company* (C. C. A. 230 Fed. 105, 106).

The Board of Tax Appeals has in several decisions approved the regulations of the Commissioner, insofar as the regulations construe the terms "initial payments", "total contract price" and "purchase price". *Dalriada Realty Co.*, 5 B. T. A. 905; *Pacheco Creek Orchard Co.*, 12 B. T. A. 1358; *J. W. McWilliams*, 15 B. T. A. 329; *Appeal of Fifty-three West Seventy-second Street, Inc.*, v. *Commissioner*, 23 B. T. A. 164.

A study of these decisions shows that the Board has not included its reasoning in approving the regulations.

The regulations which define "total contract price" were considered and construed by the United States District Court, Western District of Kentucky, in the case of *S. J. Schneider, Trustee of the Estate of Bagby-Howe Drug Company,* v. *Lucas,* decided August 3, 1929. The question was not what constituted "total contract price" but whether or not the taxpayer should report on the installment plan basis as provided in Section 212 (d) of the Revenue Act of 1926. In order to answer this question the Court had to determine what constituted the "initial payments". The District Court, by holding that the "initial payments" did not include the excess of the mortgages assumed over the basis, gave the plaintiff the right to the benefit of Section 212 (d). In determining what constituted the initial payments the Court considered the "total contract price" and stated that the total contract price should include the mortgages assumed. In its opinion, the Court said:

> "Now, giving to words their commonly accepted meaning, I have no doubt that the total contract price of the real estate involved here, within the meaning of the section quoted was $155,000.00. It is true that the $90,000.00 mortgage and the $2,000.00 mortgage which the purchaser agreed to pay were not paid to the seller. Nevertheless, the benefit flowing to the taxpayer from the payment of these mortgages by the purchaser was property, and just as much a part of the consideration as the cash which was paid as a part of the purchase price. * * *"

The decision was reversed by the Circuit Court of Appeals of the Sixth Circuit on March 6, 1931, 47 Fed. (2d) 1006, on another issue. The Circuit Court in its decision did not consider what was to be included in the "total con-

tract price", but only considered what was meant by "purchase price" and the "initial payments".

The Circuit Court of Appeals in the instant case disposes of the case of *Lucas* v. *Schneider* in the following language:

> "We cannot see that *Lucas* v. *Schneider*, (47 Fed. (2d) 1006 (C. C. A. 6)) has any bearing on the situation here. * * *" (R. 44.)

POINT III.

The payments made by the purchasers on the mortgages assumed by them to the mortgagees should be included as part of the "initial payments" and as part of the "installment payments actually received" as those terms are used in Section 212 (d) of the Revenue Act of 1926.

During the year 1924 the purchaser paid to the mortgagee on account of the mortgage assumed on the premises located at 82nd Street and Broadway the sum of $22,000.00 (R. par. 64, p. 29). This payment under respondent's theory represents a release of liability to the respondent under the bond and mortgage, and consequently becomes part of the initial payments as defined by Section 212 (d) of the Revenue Act of 1926.

During the tax year 1925 the purchaser paid to the mortgagees on account of the mortgages assumed on the premises located at 83rd Street and Broadway the sum of $22,500.00 (R. par. 66, p. 30). This constitutes part of the initial payments on the sale of the 83rd Street and Broadway property as defined by Section 212 (d) of the Revenue Act of 1926.

The receipt of this income occurs when the respondent is relieved by payment of his liability upon the mortgage assumed. This being so, the payments made by the purchaser to the mortgagee are taxable to the respondent in the proportion which the gross profit bears to the total contract price. This treatment of the payments on mortgages has been adopted both by the Commissioner and the United States Board of Tax Appeals in the case of *James M. Butler,* 19 B. T. A. 718. The Board in its opinion in that case stated (p. 728):

> "The petitioner in the instant proceeding operated under the cash receipts and disbursements basis, and the amount of $1,124.37 which he received at the time this lease was executed was income to him at the time received. However, the assumption, by the lessees, of an obligation to pay the remainder of $4,875.63 can not be considered income to the petitioner at the time of assumption. The petitioner was still liable under the mortgage and his liability was reduced only as payments were made on the principal of the mortgage by the lessees. But as such payments were made they did reduce petitioner's liability to the same extent and were income to petitioner when paid. In 1923 the lessees paid a total of $289.13 as principal accruing under the mortgage, and this will be included in petitioner's income for that year."

The Circuit Court of Appeals for the Sixth Circuit, in the *Schneider case,* 47 Fed. (2d) 1006, treated the assumption of the mortgage as the equivalent of cash, and offset the purchaser's primary obligation against the seller's secondary liability. The Court, in determining the effect in equity of the assumption of the mortgages by the purchasers, held that as between the seller and purchaser, under the laws of Kentucky, in which state this case arose,

it constituted the seller the surety and the purchaser the principal debtor to the mortgagee.

The law of New York seems the same as that of Kentucky with reference to the effect of an assumption of a mortgage. *Wadsworth* v. *Lyon*, 93 N. Y. 201; *Fairchild* v. *Lynch*, 99 N. Y. 359; *Wilcox* v. *Campbell*, 106 N. Y. 325; *Spencer* v. *Spencer*, 95 N. Y. 353; *M. Francis Wager, Res.*, v. *Thomas B. Link*, 150 N. Y. 549.

We feel the upper court was in error in treating the assumption of the mortgages as equivalent to cash. The assumption cannot be traded in. It has none of the semblance of cash. Who would buy it? It is only when the person assuming has performed by paying the mortgagee that the seller receives anything. The Finance Committee Report on page 6 hereof, and the prior regulations set forth in the Appendix, seem to confirm these conclusions. They clearly show an intention to tax cash and its equivalent in property when received.

The Circuit Court of Appeals of the Second Circuit apparently does not agree with the Court of the Sixth Circuit. See *Alfred M. Bedell* v. *Commissioner*, 30 Fed. (2d) 622; *Edith Andrews Logan* v. *Commissioner*, 42 Fed. (2d) 193.

Again in the instant case the Circuit Court of the Second Circuit has refused to recognize mortgages assumed as equivalent to property subject to tax.

Further, the Circuit Court of Appeals, Sixth Circuit, treated the mortgages assumed in two inconsistent ways. First, it held that the mortgage assumed was equivalent of cash; secondly, it held that it was a part of the initial payments only to the extent that it exceeded the basis of the seller. Thus this Court said in effect that part of the

mortgage assumed was "property other than evidences of indebtedness of the purchaser"* and part was not. This treatment, we believe, cannot be reconciled with the definition of initial payments as contained in Section 212 (d).

This inconsistency did not exist in Regulations 69 issued immediately after the passage of the Revenue Act of 1926. It was first injected by Treasury Decision 4255,** issued on January 8, 1929.

In the dissenting opinion in the *Schneider case* (C. C. A. 6), *supra*, Judge DENISON holds that the mortgage assumed is not property to the seller, but evidence of indebtedness.

The Circuit Court, in the case now before this Court, agrees with Judge DENISON. L. HAND, *J.*, in delivering the opinion of the Court, said:

> "* * * In any case Judge DENISON seems to us to have been right in saying that the assumption of a mortgage is not 'property' but 'evidence of indebtedness.' * * *"

The reason for the inconsistent treatment seems apparent. The Circuit Court of Appeals of the Sixth Circuit, the Board of Tax Appeals and the Commissioner all know that Congress intended to permit installment sales in real property; that in innumerable sales of realty mortgages are involved; and that if these were treated in their entirety as equivalent of cash, and part of the initial payments, the purpose of the statute would be defeated. This inconsistent position need not be followed to prevent the defeat of the statute. The construction urged by respondent overcomes the inconsistency and gives just results.

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*Excerpt from 212 (d) of Revenue Act of 1926.

**See footnote under Article 45, Regulations 69, in Appendix.

POINT IV.

The petitioner did not receive as income from the sale of the property in the year 1925 the excess of the mortgages assumed over the basis of the property to the petitioner, and such excess should not be reported as income in that year.

For the year 1925 the petitioner treated as income the amount of $77,967.00 on the theory that the mortgages assumed on the sale of the 83rd Street and Broadway property in 1925 exceeded the cost basis to the respondent by that amount. They did exceed the basis; but that fact does not create income. The respondent's right to report the profits from the sale of the properties on the installment plan being conceded, it follows that the excess of the mortgages assumed over the basis of the property sold in the year 1925 should not be reported as income in that year.

L. HAND, *J.*, in the Circuit Court opinion in this case, in discussing the excess of the assumed mortgages over the base, stated:

> "We can not see that Lucas *v.* Schneider (47 F. (2d) 1006 (C. C. A. 6)) has any bearing on the situation here. The ruling would indeed deprive the petitioner of any recourse to the section at all, which the commissioner does not assert. As applied to the sale in 1925, it would also require us to treat the excess of the assumed mortgages over the 'base' as 'property' received at once. But we could scarcely stop there; we should be obliged to treat the whole of the assumed mortgages in the same way, and that would suit neither party. In any case Judge DENISON seems to us to have been right in saying that the assumption of a mortgage is not 'property' but 'evidence of indebtedness.' * * *"

The item of $77,967.00, representing the excess of the mortgages assumed over the base, when added to the initial payments covering the sale of the property at 83rd Street and Broadway in the year 1925, results in an amount which is less than 25% of the total purchase price of $2,165,000.00. This fact distinguishes the instant case from the *Schneider* case. The petitioner asserts in his brief, pages 17 and 18:

> "* * * The excess of assumed mortgages over the 'basis' is properly treated as realized income to the taxpayer at the time of assumption of liability by the purchaser, for the taxpayer is then relieved of primary liability; and to the extent of such excess, theretofore received as a loan, the taxpayer has at that time derived income. See *United States* v. *Kirby Lumber Co.*, 284 U. S. 1."

The decision in the case of *United States* v. *Kirby Lumber Co., supra,* provides no support for the Commissioner's treatment of this item. In that case, the Supreme Court held "that where a corporation retires its own bonds at a price less than the issuing price or face value, the excess of the issuing price or face value over the purchase price is taxable income for the taxable year." The retirement of an obligation is entirely different from the assumption of an obligation. In effect, the retirement of a bond obligation cancels it forever, while the assumption keeps the obligation alive; the obligor being relieved only when payments have actually been made thereon.

The petitioner in advancing his theory of the proper treatment of the excess of the assumed mortgages over the basis, cites in support the case of *United States* v. *Kirby Lumber Co., supra,* also the cases of *Clemmons* v. *Commissioner,* 54 Fed. (2d) 209 (C. C. A. 5); *Ford* v. *Commis-*

sioner, 51 Fed. (2d) 206 (C. C. A. 6), certiorari denied, 284 U. S. 666; *Board* v. *Commissioner,* 51 Fed. (2d) 73 (C. C. A. 6), certiorari denied, 284 U. S. 658; *Commissioner* v. *Moir,* 45 Fed. (2d) 356 (C. C. A. 7).

These cases support the statement of the petitioner that the receipt of income is not deferred for purposes of taxation beyond the year in which received because there exists some potential liability of which a loss may be sustained. But these cases do not affect the instant case as they relate to the actual receipt of cash in the taxable year. In the instant case the respondent has not actually received cash as the result of the assumption of the mortgages. Further, the transactions involved in the instant case relate to the reporting of profit on the installment plan, which method was not involved in the cases cited by the petitioner.

The respondent, as an alternative to its contention that the "total contract price" includes the mortgages assumed by the purchaser, urges that, in the event that this Court holds that the definition of the Commissioner as to "total contract price" is correct, nevertheless, the item of $77,976.00 is not a separate item in the year of sale, but should be included as part of the total profit, namely, $642,967.00, and this profit should be reported over the period during which the smaller amount of $565,000.00 will be received. It is the respondent's theory that if the statute be construed as to exclude mortgages assumed from the "total contract price", then Congress intended to permit the taxpayer to treat the cash payments received from the purchaser as income in each year of their receipt; this being so, even though as in the respondent's case the income would be in excess of 113-plus per cent. in each year of their receipt. This difficulty was never expected by Congress in enacting Section

212 (d) as in no case would the profit exceed 100 per cent. if the "total contract price" included the mortgages assumed. It is the petitioner's theory that the statute limits the reporting of profit under the installment method to a percentage of 100 per cent. This theory would always be correct if the "total contract price" included the mortgages assumed. But if the petitioner's theory that the "total contract price" does not include the mortgages assumed is correct, then there is no foundation for the theory that the statute limits the reporting of profit to a percentage of 100 per cent. If the petitioner is correct in his theory, then Congress certainly failed to enact the statute which it originally intended to enact. If the basis which is the amount allocable as the cost of the equity, namely, $565,000.00, is the only amount that can be used in determining profit, then it seems clear that the amount of $77,967.00, which is now in dispute, would be non-taxable in the year of sale. It would only be taxable over the period in which the seller was relieved of liability on the mortgages assumed. Either construction of the statute would result in the omission or exclusion of the amount of $77,967.00 from the income to be reported in the tax year 1925.

Conclusion.

The decision below is correct and should be upheld.

Respectfully submitted,

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APPENDIX.

Salient Portions of Regulations Covering Installment Sales Issued by the Commis.

EXCERPTS FROM REGULATIONS 69 ISSUED UNDER THE REVENUE ACT OF 1926.

Art. 42. Sale of personal property on installment plan.—

* * * The rule prescribed is that a person who regularly sells or otherwise disposes of personal property on the installment plan, whether or not title remains in the vendor until the property is fully paid for, **may return as income therefrom in any taxable year that proportion of the installment payments actually received in that year which the total or gross profit** (that is, sales less cost of goods sold) **realized or to be realized when the property is paid for, bears to the total contract price.** (See section 212 (d).) Thus the income of a dealer in personal property on the installment plan may be ascertained by taking as income that proportion of the **total payments received** in the taxable year from installment sales (such payments being allocated to the year against the sales of which they apply), which the total or gross profit realized or to be realized on the total installment sales made during each year bears to the total contract price of all such sales made during that respective year. * * *

Art. 44. Sale of real property involving deferred payments.—Under section 212 (d) deferred-payment sales of real property fall into two classes when considered with respect to the terms of sale, as follows:

(1) Sales of property on the installment plan, that is, sales in which the payments received in cash or property other than evidences of indebtedness of the purchaser during the taxable year in which the sale is made do not exceed one-fourth of the purchase price.

(2) Deferred-payment sales not on the installment plan, that is, sales in which the payments received in cash or property other than evidences of indebtedness of the purchaser during the taxable year in which the sale is made exceed one-fourth of the purchase price.

Sales falling within class (1) and class (2) alike include (a) agreements of purchase and sale which contemplate that a conveyance is not to be made at the outset, but only after all or a substantial portion of the purchase price has been paid, and (b) sales where there is an immediate transfer of title, the vendor being protected by a mortgage or other lien as to deferred payments.

*In the sale of mortgaged property the amount of the mortgage, whether the property is merely taken subject to the mortgage or whether the mortgage is assumed by the purchaser, shall not be considered as a part of the "initial payments" or of the "total contract price", but shall be included as part of the "purchase price", as those terms are used in section 212 (d), in articles 42 and 45, and in this article. Commissions and other selling expenses paid or incurred by the vendor are not to be deducted or taken into account in determining the amount of the "initial payments", the "total contract price", or the "purchase price".

Art. 45. Sale of real property on installment plan.—In transactions included in class (1) in article 44, **the vendor may return as income from such transactions in any taxable year that proportion of the installment payments actually received in that year which the total profit realized or to be realized when the property is paid for bears to the total contract price.**

If for any reason the purchaser defaults in any of his payments, and the vendor returning income on the installment basis repossesses the property, the entire amount received on installment payments and retained by the vendor, less the sum of the profits previously returned as income and an amount representing proper adjustment for exhaustion, wear and tear, obsolescence, amortization, and depletion of the property while in the hands of the purchaser, will be income of the vendor for the year in which the property is repossessed, and the basis of the property in the hands of the vendor will be the original basis at the time of the installment sale.

If the vendor chooses as a matter of consistent practice to return the income from installment sales on the straight accrual or cash receipts and disbursements basis, such a course is permissible, and the sales will be treated as deferred-payment sales not on the installment plan.

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*The last paragraph of Article 44 of Regulations 69 was amended to include the following, by Treasury Decision 4255, VIII—1 Cumulative Bulletin, page 165, approved January 8, 1929:

In the sale of mortgaged property the amount of the mortgage, whether the property is merely taken subject to the mortgage or whether the mortgage is assumed by the purchaser, shall be included as a part of the "purchase price", but the amount of the mortgage, to the extent it does not exceed the basis to the vendor of the property sold, shall not be considered as a part of the "initial payments" or of the "total contract price", as those terms are used in section 212 (d), articles 42 and 45, and in this article. Commissions and other selling expenses paid or incurred by the vendor are not to be deducted or taken into account in determining the amount

sioner of Internal Revenue Under the Revenue Acts of 1924 and 1926

EXCERPTS FROM REGULATIONS 65 ISSUED UNDER THE REVENUE ACT OF 1924.[4]

Art. 42. Sale of personal property on installment plan.—* * *

The rule prescribed is that in the sale or contract for sale of personal property on the installment plan, whether or not title remains in the vendor until the property is fully paid for, **the income to be returned by the vendor will be that proportion of each installment payment which the gross profit to be realized when the property is paid for bears to the gross contract price. Such income may be ascertained by taking as profit that proportion of the total cash collections received in the taxable year from installment** sales (such collections being allocated to the year against the sales of which they apply), which the annual gross profit to be realized on the total installment sales made during each year bears to the gross contract price of all such sales made during that respective year. * * *

Art. 44. Sale of real estate involving deferred payments.—Deferred-payment sales of real estate ordinarily fall into two classes when considered with respect to the terms of sale, as follows:

(1) Installment transactions, in which the initial payment is relatively small (generally less than one-fourth of the purchase price) and the deferred payments usually numerous and of small amount. They include (a) sales where there is immediate transfer of title when a small initial payment is made, the seller being protected by a mortgage or other lien as to deferred payments, and (b) agreements of purchase and sale which contemplate that a conveyance is not to be made at the outset, but only after all or a substantial portion of the agreed installments have been paid.

(2) Deferred-payment sales not on the installment plan, in which there is a substantial initial payment (ordinarily not less than one-fourth of the purchase price), deferred payments being secured by a mortgage or other lien. Such sales are distinguished from sales on the installment plan by the substantial character of the initial payment and also usually by a relatively small number of deferred payments.

In determining how these classes shall be treated in levying the income tax, **the question in each case is whether the income to be reported for taxation shall be based only on amounts actually received in a taxing year,** or on the entire consideration made up in part of agreements to pay in the future.

Art. 45. Sale of real estate on installment plan.—In the two kinds of transactions included in class (1) in the foregoing article, **installment obligations assumed by the buyer are not ordinarily to be regarded as having a fair market value, and the vendor may report as his income from such transactions in any year that proportion of each payment actually received in that year which the gross profit to be realized when the property is paid for bears to the gross contract price.** If the return is made on this basis and the vendor repossesses the property after default by the buyer, retaining the previous payments, the entire amount of such payments, less the profit previously returned, will be income to the vendor and will be so returned for the year in which the property was repossessed, and the property repossesed must be included in the inventory at its original cost to himself (less any depreciation as defined in articles 161 and 162). If the taxpayer chooses as a matter of settled practice consistently followed to treat the obligations of the purchaser as having a fair market value and to report the profit derived from the entire consideration, cash and deferred payments, as income for the year when the sale is made, this is permissible. If so treated, the rule prescribed in article 46 will apply.

[4]Articles 42, 44 and 45 were substantially the same in Regulations 45 and 62 of the Revenue Acts of 1918 and 1921, respectively.

ILLUSTRATIVE JOURNAL ENTRIES FOR RECORDING PROFITS ON THE INSTALLMENT PLAN

(1)	Due from Purchaser	$2,100,000.00	
	To Sale of Property		$2,100,000.00
	(82nd Street and Broadway)		
	To record the purchase of 82nd Street and Broadway property by vendee for a contract price of $2,100,000.00; payable $300,000.00 in cash, purchase money mortgage of $700,000.00 and assumption of $1,100,000.00 first mortgage. See detail of installment payments, etc.		
(2)	Sales of Property (82nd Street and Broadway)	$ 558,676.52	
	To Deferred Profit on Sale		558,676.52
	To transfer excess of sales price over cost to unrealized profit on sale of 82nd Street and Broadway property, reported on installment plan.		
(3)	First Mortgage Payable	$ 22,000.00	
	To Due from Purchaser		22,000.00
	To record the installment due December 1, 1924 and paid on first mortgage direct to mortgagee by purchaser.		
(4)	Deferred Profit on Sale of 82nd Street and Broadway	$ 93,644.83	
	To Realized Profit on Sale		93,644.83
	To record the profit applicable to year 1924 on sale of 82nd Street and Broadway property, reported on installment plan as follows:		
	Cash received on Sale..... $300,000.00		
	Installment received on purchase money mortgage.. 30,000.00		
	Installment on first mortgage paid in 1924 by purchaser to mortgagee.... 22,000.00		
	TOTAL $352,000.00		

Percentage of profit=.26603644 x 352,000.00=93,644.83